

## Preservation of value brings preferential status

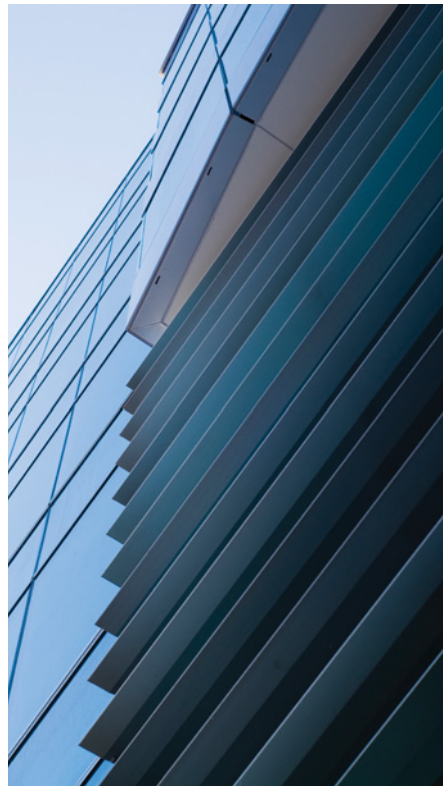
Another preferential creditor category, introduced into both the Companies Act (liquidations) and the Insolvency Act (bankruptcies) in 2007, opens new possibilities for unsecured creditors reacting to a financially distressed debtor.

The provisions give preference to creditors making payments or giving indemnities to protect, preserve the value of, or recover assets of the debtor for the benefit of the debtor's creditors. This could encompass, for example, payments to avoid a secured creditor taking enforcement action likely to result in devaluation of assets.

In at least one case prior to the amendments, a creditor who arguably preserved the value of assets by providing professional services to an insolvent company successfully defended a voidable preference claim under the old "ordinary course of business" defence. However, the scope of that defence was very limited for such creditors.

Importantly, the creditor's preference extends to (i) the sum paid, and (ii) any further amount received by the liquidator/assignee by realisation of the assets protected, preserved or recovered. The preference for the amount received from realisation extends to the value of the creditor's unsecured debt - it is not limited to the increase in value.

As a result, while the preference is not likely to affect secured creditors, it may make a significant difference to other unsecured creditors. The preserving creditor ranks ahead of most preferential creditors, including employees and the IRD.



This may see some unsecured creditors using the provision to attempt to improve their position. The "benefit" test is objective, so the priority is not ruled out merely because the creditor is ultimately acting in its own interests.

Consider, for example, a shareholder owed \$10,000 by the debtor property development company. Facing non-recovery on a mortgagee sale, the shareholder advances a further \$5,000 to forestall a mortgagee sale and allow completion of the development. If the company is then liquidated, the shareholder might seek to claim up to \$15,000 as a preferential debt if it can show that its actions resulted in an improved return from the sale of at least \$5,001 (the additional dollar comprising a benefit to the body of creditors). Alternatively, a Court might take the view that the benefit to the creditors must be to the final outcome for all creditors once the preference is taken into account, though this seems to add a gloss to the words of the provisions.

Developments in this area should be monitored, as they may result in changes to the way creditors act when potential insolvency threatens the value of a debtor's assets.

### CASE LAW UPDATE

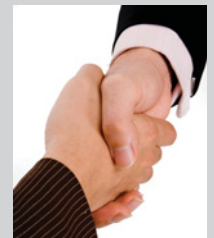
## Withdrawing surrender of a charge

*A J Park v Nepri Ltd* (in liq) (15/2/10, Associate Judge Doogue) provides new guidance on withdrawing deemed surrender of a charge.

Under s 305 Companies Act 1993, a liquidator can give notice requiring a secured creditor to elect whether to enforce its charge or surrender it within 20 working days. Failure to respond by the creditor results in deemed surrender of the charge.

In *Nepri*, the creditor applied to withdraw its deemed surrender, on the basis that it had made its intention to enforce its charge clear at a meeting with the liquidator. That was disputed by the liquidator, but the Court granted the creditor its withdrawal, on the basis that (i) a creditor's misunderstanding justified withdrawal of a deemed surrender in some circumstances; and (ii) the liquidator would not suffer "relevant prejudice" (which would include delay and expense). The Court noted that prejudice to recovery for the body of creditors was not relevant to the issue.

The purpose of s 305 is to give liquidators certainty. *Nepri* might be seen to erode that purpose, in that creditors acting under a misapprehension about their obligations to enforce or surrender may well obtain relief from the Court where there was otherwise a deemed surrender.



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# The latest word on third party releases

Many corporate debtors seeking to compromise their debts will have associated third parties who are potentially liable for the same or associated debts - most obviously, guarantors and directors. Can such third parties be released from liabilities by virtue of either (i) a Deed of Company Arrangement (DOCA) or (ii) a creditor's compromise under the Companies Act? The likely answer in relation to a DOCA is "no". The position on Companies Act compromises is less clear.

## DOCAs

A key objective of voluntary administration is to maximise the chances of the debtor company's business continuing. The primary means of achieving this is through execution of a DOCA by the requisite majority of creditors. The DOCA must specify certain matters (including the extent to which the company will be released from its debts), but there is no provision prohibiting the DOCA from releasing third parties. The Act provides that release of the company from a debt does not release a guarantor. But what about a DOCA that purports to release the guarantor?

Generally, creditors may of course agree to release third parties. The difference under a compromise proposal, including a DOCA, is that a majority of creditors may seek to enforce such release on a minority. In the case of some potentially exposed third parties - for example, directors who are providing further assistance which will help ensure the continuation of the business - this may be justified. In other cases, it may be unfair. Without an express provision

in the Act dealing with the matter, a Court should be reluctant to assume such a right.

That is the approach affirmed recently by the High Court of Australia in *Lehman Brothers*. There, the DOCA sought to prevent creditors taking action against other companies in the group. The Court held that these provisions were not enforceable under the equivalent Australian provisions, and the whole DOCA was set aside. This judgment should be persuasive on a New Zealand court, given the similarities between the trans-Tasman regimes. However, until the issue is heard in New Zealand, the outcome cannot be assumed.

## Companies Act compromises

Broadly, Part 14 of the Act is an inflexible compromise procedure which is administered by the company itself. Part 15 is more flexible but requires Court approval in addition to the requisite creditor majority.

Generally, voluntary administration is intended to be a more attractive procedure for ensuring a company's survival. It would arguably be a flaw in that philosophy for Parts 14 and 15 to provide release of third parties when a DOCA cannot, in that potentially exposed directors might be more inclined to try those procedures ahead of administration. Nevertheless, the Federal Court of Australia has concluded that the Australian equivalent could extinguish third party liability. The Court regarded the fact that the relevant compromise procedure required Court approval as important, as the Court could decline to

approve the compromise if release of third parties would cause prejudice. However, unlike *Lehman Brothers*, this decision is unlikely to have persuasive value here, because the statutory compromise procedure in Australia is quite different.

As with DOCAs, there is no express provision in Parts 14 or 15 dealing with third party liability. While such releases might be challenged before the Court by a dissenting creditor, in the case of Part 14 compromises that would require such creditor to commence proceedings and incur significant expense. In the case of Part 15 compromises, the requirement for Court approval from the outset may provide a sufficient safeguard.

## A word of warning

Compromises do, in practice, sometimes include third party releases. Given the uncertainty, debtors might be advised to "take the risk". However, the risk is significant, especially as a Court may simply set aside the entire compromise if it finds third party liability cannot be released. A further risk is that if a third party release is not binding on dissenting creditors, creditors who did agree to it might nevertheless be held to be bound. The matter needs clarification from the New Zealand Courts and it is to be hoped that this will come. In the meantime, debtors, creditors and advisers need to be aware of the issue when considering company compromises and the best procedure to be adopted in relation to them.

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